



Audit



Report

INSPECTOR GENERAL, DOD, OVERSIGHT
OF THE ARMY AUDIT AGENCY AUDIT OF
THE FY 2000 ARMY WORKING CAPITAL FUND
FINANCIAL STATEMENTS

Report No. D-2001-063

February 28, 2001

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Acronym

AAA

Army Audit Agency



**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884**

February 28, 2001

**MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE**

**SUBJECT: Audit Report on Inspector General, DoD, Oversight of the Army Audit
Agency Audit of the FY 2000 Army Working Capital Fund Financial
Statements (Report No. D-2001-063)**

We are providing this audit report for your information and use and for transmittal to the Director, Office of Management and Budget. It includes our endorsement of the Army Audit Agency disclaimer of opinion on the FY 2000 Department of the Army Working Capital Fund financial statements, along with excerpts from the "Army Working Capital Fund Principal Financial Statements for Fiscal Year 2000: Summary Audit Report," February 9, 2001. An audit of the Army Working Capital Fund financial statements is required by the Chief Financial Officers Act of 1900, as amended by the Federal Financial Management Act of 1994. Because this report contains no findings or recommendations, written comments are not required.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Richard B. Bird at (703) 604-9159 (DSN 664-9159) (rbird@dodig.osd.mil) or Mr. Carmelo G. Ventimiglia at (317) 510-3852 (DSN 699-3852) (cventimiglia@dodig.osd.mil.) See Appendix B for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma

David K. Steensma
Acting Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. D-2001-063
(Project No. D2001FI-0035)

February 28, 2001

Inspector General, DoD, Oversight of the Army Audit Agency Audit of the FY 2000 Army Working Capital Fund Financial Statements

Executive Summary

Introduction. Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994, requires DoD to prepare annual audited Army Working Capital Fund financial statements. Office of Management and Budget Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," October 16, 2000, establishes the minimum requirements for audits of these financial statements. This Bulletin requires the Inspector General, DoD, to express an opinion on the DoD financial statements and to report on the adequacy of internal controls and compliance with laws and regulations. We delegated the audit of the FY 2000 Department of the Army Working Capital Fund financial statements to the Army Audit Agency.

Objectives. Our objectives were to oversee the Army Audit Agency audit of the FY 2000 Department of the Army Working Capital Fund financial statements to verify whether we can rely on their work and to determine whether the Defense Finance and Accounting Service Indianapolis consistently and accurately compiled financial data from field organizations and other sources for the FY 2000 Army Working Capital Fund financial statements. This report focuses on the oversight objective. See Appendix A for a discussion of the audit process.

Results. The Army Audit Agency was unable to express an opinion on the FY 2000 Army Working Capital Fund financial statements. We concur with the Army Audit Agency disclaimer of opinion; our endorsement of that disclaimer is Exhibit 1. Excerpts of the Army Audit Agency report is included as Exhibit 2 and provide the reasons for the disclaimer of opinion and identify the material weaknesses and reportable conditions associated with the internal controls and compliance with laws and regulations. The complete Army Audit Agency report, "Army Working Capital Fund Principal Financial Statements for Fiscal Year 2000: Summary Audit Report," February 9, 2001, can be accessed on the Internet at <http://www.aaa.army.mil>. The FY 2000 Army Working Capital Fund Principal Financial Statements can be accessed on the Internet at www.dtic.mil/comptroller.

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2. Excerpts from Army Audit Agency Report, "Army Working Capital Fund Principal Financial Statements for FY 2000: Summary Audit Report"

Appendix A. Audit Process

Scope and Methodology

Audit Work Performed. To fulfill our responsibilities under Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994, and Office of Management and Budget Bulletin No. 01-02, "Audit Requirements for Federal Financial Statement," October 16, 2000, we performed oversight of the independent audit conducted by the Army Audit Agency (AAA) of the FY 2000 Army Working Capital Fund financial statements. We reviewed the AAA audit approach and monitored audit progress at key points.

Reviewing the AAA Audit Approach. We used the "Federal Financial Statement Audit Manual," January 1993, issued by the President's Council on Integrity and Efficiency, and the "Financial Audit Manual," December 12, 1997, issued by the General Accounting Office, as criteria for reviewing the AAA audit approach. We reviewed the engagement letter, cycle memorandums, and audit programs. In addition, we participated in AAA conferences on the Army Working Capital Fund financial statements. The conferences covered the AAA planning and formulation of audit strategy and included presentations on issues that developed during the AAA work.

Monitoring Audit Progress. Through the DoD Financial Statement Audit Executive Steering Committee, and an integrated line-item oversight effort, we provided a forum for a centrally managed exchange of guidance and information. We monitored the progress of the audit through site visits, reviews of key working papers of AAA audit results and conclusions, and attendance at meetings between AAA and audit client. We also reviewed and commented on audit reports issued by AAA, including the summary audit report, which included discussions of issues on internal controls and compliance with laws and regulations. In addition, we co-performed audit work with AAA to verify the adequacy of support for accounting entries made during the compilation of the financial statements.

DoD-Wide Corporate-Level Government Performance and Results Act Coverage. In response to the Government Performance and Results Act, the Secretary of Defense annually establishes DoD-wide corporate-level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following corporate-level goal, subordinate performance goal, and performance measure:

FY 2001 DoD Corporate-Level Goal 2: Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the Revolution in Military Affairs, and reengineer the Department to achieve a 21st century infrastructure. (01-DoD-02)

FY 2001 Subordinate Performance Goal 2.5: Improve DoD financial and information management. (01-DoD-2.5)

FY 2001 Performance Measure 2.5.2: Achieve unqualified opinions on financial statements. (01-DoD-2.5.2)

DoD Functional Area Reform Objectives and Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objective and goal.

Financial Management Area. Objective: Strengthen internal controls.
Goal: Improve compliance with the Federal Managers' Financial Integrity Act. (FM-5.3)

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in the DoD. This report provides coverage of the Defense Financial Management high-risk area.

Audit Type, Period, and Standards. We performed this financial statement audit from October 12, 2000 through February 9, 2001, in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. We did not use computer-processed data to conduct our oversight of the AAA audit of the FY 2000 Army Working Capital Fund financial statements.

Contacts During the Audit. We visited or contacted individuals and organizations in the DoD audit and accounting community. Further details are available on request.

Prior Coverage

The General Accounting Office and the Inspector General, DoD, have conducted multiple reviews related to financial statement issues. General Accounting Office reports can be accessed on the Internet at <http://www.gao.gov>. Inspector General, DoD, reports can be accessed on the Internet at <http://www.dodig.osd.mil>.

Appendix B. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organization

Director, Defense Finance and Accounting Service

Non-Defense Federal Organization

Office of Management and Budget
General Accounting Office

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member (Cont'd)

House Subcommittee on Government Efficiency, Financial Management, and
Intergovernmental Relations, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International
Relations, Committee on Government Reform
House Subcommittee on Technology and Procurement Policy, Committee on
Government Reform

**Exhibit 1. Inspector General, DoD,
Endorsement Memorandum**



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

February 9, 2001

**MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE**

**SUBJECT: Endorsement of the Disclaimer of Opinion on the FY 2000 Army Working
Capital Fund Financial Statements (Project No. D2001FI-0035)**

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspectors General. We delegated to the Army Audit Agency (AAA) the audit of the FY 2000 Army Working Capital Fund financial statements. Summarized as follows are the AAA disclaimer of opinion on the FY 2000 Army Working Capital Fund financial statements and the results of our review of the AAA audit. The information provided in this memorandum contains reasons for the AAA disclaimer. We endorse the disclaimer of opinion expressed by AAA.

Disclaimer of Opinion. The AAA disclaimer of opinion on the FY 2000 Army Working Capital Fund financial statements, dated February 9, 2001, states that AAA was unable to express an opinion on the financial statements. We concur with the AAA disclaimer of opinion. The AAA disclaimer of opinion concludes that financial systems and processes, as well as associated internal control structures, were inadequate to produce reliable financial information. For example, accounting systems lacked adequate audit trails. In addition, the reported values in the financial statements were derived from non-financial feeder systems and budgetary systems that were not designed to report information in business-like financial statements. AAA could not verify the following:

- inventory and related property;
- the cost and depreciation recorded for property, plant, and equipment;
and
- amounts reported on the Statement of Net Cost, Statement of Changes in Net Position, Statement of Budgetary Resources, and the Statement of Financing.

Internal Controls. The AAA tested internal controls but did not express a separate opinion because opining on internal controls was not one of its objectives. However, AAA determined that internal controls did not provide reasonable assurance of achieving the internal control objectives described in Office of Management and Budget Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," dated October 16, 2000. For example, the Army and the Defense Finance and Accounting Service did not do the following:

- reconcile inventory logistical and accounting records,
- complete physical inventories of inventory and related property,

- maintain support for equity transactions affecting the Statement of Changes in Net Position,
- control access to the Commodity Command Standard System, and
- adhere to procedures for compiling the financial statements.

Specifically, \$44 billion of the \$212.2 billion in accounting adjustments lacked audit trails. The Army and the Defense Finance and Accounting Service recognized many of the financial reporting weaknesses and reported them in their FY 2000 Annual Statements of Assurance. Details on the internal control weaknesses will be provided in separate AAA reports.

Compliance With Laws and Regulations. The AAA identified areas of noncompliance with laws and regulations. Under the Federal Financial Management Improvement Act of 1996, the AAA work showed that financial management systems did not substantially comply with Federal financial management system requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level.

Review of the Army Audit Agency Work. To fulfill our responsibilities for determining the accuracy and completeness of the independent audit that AAA conducted, we reviewed the audit approach and planning and monitored progress at key points. We also performed other procedures necessary to determine the fairness and accuracy of the approach and conclusions.

We reviewed the AAA work on the FY 2000 Army Working Capital Fund financial statements from March 14, 2000, through February 9, 2001, in accordance with generally accepted Government auditing standards. We found no indications that we could not rely on the AAA disclaimer of opinion or its related evaluation of internal controls and compliance with laws and regulations.



David K. Steensma
Deputy Assistant Inspector General
for Auditing

**Exhibit 2. Excerpts from Army Audit
Agency Report, "Army
Working Capital Fund
Principal Financial
Statements for FY 2000:
Summary Audit
Report"**

Army Working Capital Fund Principal Financial Statements for Fiscal Year 2000

Summary Audit Report

**9 February 2001
Audit Report: AA 01-175**



U.S. Army Audit Agency





DEPARTMENT OF THE ARMY
OFFICE OF THE AUDITOR GENERAL
3101 PARK CENTER DRIVE
ALEXANDRIA, VA 22302-1596

9 February 2001

Acting Secretary of the Army

This is our report on our efforts to audit the Army Working Capital Fund Financial Statements for Fiscal Year 2000. It contains our disclaimer of opinion on the Principal Financial Statements and the results of our review of internal controls and compliance with significant provisions of laws and regulations. This report also contains our conclusions on whether the Army's financial management systems comply with the requirements of the Federal Financial Management Improvement Act of 1996.

In separate reports, we will provide more details and recommend corrective actions to address the weaknesses in internal controls and compliance with the laws and regulations issues we discuss in this report. This report doesn't contain recommendations.

I appreciate the courtesies and cooperation extended to us during the audit.


FRANCIS E. REARDON, CPA
The Auditor General

For more information about this audit, please call the Army Working Capital Fund Division at (703) 681-8349. For copies of the Summary of Audit or for extra copies of this report, please call (703) 681-9863.

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BACKGROUND

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BACKGROUND

Chief Financial Officers Act of 1990

On 15 November 1990, the 101st Congress of the United States passed the Chief Financial Officers Act of 1990 (Public Law 101-576). Congress passed the act to bring more effective general and financial management practices to the Federal Government; improve systems of accounting, financial management, and internal controls; and provide for the production of complete, reliable, timely, and consistent financial information. Under the act, DOD was required to prepare—and have audited—financial statements covering substantial commercial functions, revolving funds, and trust funds. The Army Working Capital Fund is a revolving fund that meets the criteria of the act.

Federal Financial Management Act

The Federal Financial Management Act of 1994 (Public Law 103-356) made the Chief Financial Officers Act permanent and established an annual deadline of 1 March for providing audited financial statements to the Office of Management and Budget. (This law is also referred to as the Government Management Reform Act of 1994.)

Financial Statements

Federal agencies are required to submit a set of financial statements, overview, and notes that were standardized by the Office of Management and Budget. The Army is required to prepare the following financial statements:

- Balance Sheet.
- Statement of Net Cost.
- Statement of Changes in Net Position.
- Statement of Budgetary Resources.
- Statement of Financing.

The Army is also required to prepare and submit supplementary information that presents additional details on the information included in the statements listed above. The additional required information is:

- **Disaggregated Statement of Budgetary Resources.** This information shows the use of budgetary resources by business area.
- **Segment Information.** Additional supplementary information is required showing information on assets and liabilities by entity.

Audit Responsibility

The Inspector General, DOD, is responsible for auditing financial statements within the Department of Defense. As delegated by, and in coordination with the Inspector General, DOD, we were engaged to audit the Principal Financial Statements as of and for the year ended 30 September 2000, including an evaluation of related internal controls and compliance with laws and regulations.

AUDITOR'S REPORT

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DEPARTMENT OF THE ARMY
OFFICE OF THE AUDITOR GENERAL
3101 PARK CENTER DRIVE
ALEXANDRIA, VA 22302-1596

9 February 2001

Acting Secretary of the Army

The Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994, requires the Army to prepare annual financial statements for the Army Working Capital Fund. As delegated by, and in coordination with the Inspector General, DOD, we were engaged to audit the Principal Financial Statements as of and for the year ended 30 September 2000.

We weren't able to determine whether the accompanying Balance Sheet of the Army Working Capital Fund as of 30 September 2000 and the related Statement of Net Cost, Statement of Changes in Net Position, Statement of Budgetary Resources, and Statement of Financing for the end of the year were fairly presented and reliable. The Army Working Capital Fund is unable to fully implement all elements of generally accepted accounting principles and the Office of Management and Budget Bulletin 97-01 (Form and Content of Agency Financial Statements) due to limitations of its financial management processes and systems. Therefore, the scope of our work wasn't sufficient to enable us to express, and we do not express, an opinion on these financial statements. We discuss some of the accounting system and scope limitations in the following paragraphs.

The accounting systems lack sufficient audit trails for us to be able to satisfy ourselves that the information included in the Principal Financial Statements (Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, Statement of Budgetary Resources, and Statement of Financing) were reliable. The reported values in the financial statements are derived from nonfinancial feeder systems or by budgetary systems. These systems were designed to support reporting requirements focusing on maintaining accountability for assets and reporting on the status of Federal appropriations rather than reporting the information in business-like financial statements.

We weren't able to attest to the reasonableness of the amount reported for inventory and related property, which represented about 79 percent of total assets. There were four main issues that limited the scope of our review of inventory and prevented us from satisfying ourselves that the amount reported for Inventory, Net was reliable. These issues were accounting system deficiencies, incomplete physical inventories, and

internal control weaknesses in accounting for inventory held for repair and inventory in-transit.

We weren't able to determine if the Property, Plant and Equipment, Net account was fairly presented. During FY 00, the Army Working Capital Fund activities implemented the Defense Property Accounting System for all of its property, plant and equipment. The Army believed that the new system provided more reliable values for the Balance Sheet and depreciation expense for the Statement of Net Cost. As a result of the implementation, the net book value of property, plant and equipment was reduced by about \$606 million from FY 99 to FY 00. We weren't able to satisfy ourselves as to the reported value (about \$1.2 billion or about 9 percent of total assets) for property, plant and equipment.

We believe the accounting weaknesses may also affect the usefulness of information contained in the accompanying overview and any other financial management information taken from the same data sources used to prepare the financial statements.

The consolidating financial information and the information regarding transactions with other Federal agencies isn't a required part of the Principal Financial Statements, and we didn't audit and do not express an opinion on the information. The consolidating information is presented for additional analysis of the Principal Financial Statements rather than to present the financial position, net cost of operations, changes in net position, use of budgetary resources, and sources and uses of financing resources. The information regarding transactions with other Federal agencies is required supplemental information.


FRANCIS E. REARDON, CPA
The Auditor General

REPORT ON INTERNAL CONTROLS

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REPORT ON INTERNAL CONTROLS

In planning and performing our review of the Army Working Capital Fund FY 00 Financial Statements, we considered the Army's and the Defense Finance and Accounting Service's (Defense Accounting Service's) internal controls over financial reporting by:

- Obtaining an understanding of the Army's and the Defense Accounting Office's internal controls.
- Determining whether internal controls had been placed in operation.
- Assessing control risk.
- Performing tests of the selected internal controls to help us determine our auditing procedures for the purpose of reviewing the financial statements.

We limited our internal control testing to those internal controls necessary to achieve the objectives described in Office of Management and Budget Bulletin 01-02 (Audit Requirements for Federal Financial Statements). We didn't test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. The objective of our review was not to provide an opinion on internal controls. Consequently, we do not express an opinion on internal controls.

Our consideration of internal controls wouldn't necessarily disclose all matters that might be reportable conditions under standards established by the American Institute of Certified Public Accountants and Office of Management and Budget Bulletin 01-02. Reportable conditions represent significant deficiencies in the design or operation of the internal controls that, in our judgment, could adversely affect the ability to record, process, summarize, and report financial data consistent with assertions by management in the financial statements. Some reportable conditions are considered material weaknesses. Material weaknesses are reportable conditions involving deficiencies in the design or operation of internal controls leading to an unacceptable high risk that losses, noncompliance, or material misstatements in the financial statements may occur and not be promptly detected.

We noted certain matters involving internal controls and their operation that we considered material weaknesses. We discuss those matters in the following paragraphs.

FY 00 AUDIT RESULTS

During FY 00, we focused on controls related to compiling the financial statements and to transactions affecting balance sheet accounts—accounts receivable, other assets, inventory, accounts payable, and fund equity. Both the Army and the Defense Accounting Service continued their efforts to correct problems that affected the ability to prepare reliable and useful financial statements. However, in some instances, the corrective actions may take years to complete. Until the Army and the Defense Accounting Service complete the corrective actions and minimize the impact of the poor internal controls, they will continue to have problems preparing useful financial statements. We summarize the weaknesses in the following paragraphs.

Compilation of the Financial Statements

The Defense Finance and Accounting Service-Indianapolis Center for Sustaining Forces (Indianapolis Center) didn't follow its established procedures for compiling the financial statements. Higher levels of management reviewed the adjustment vouchers as required by Defense Accounting Service procedures. But, in some instances, the reviews seemed cursory because the senior managers appeared to approve adjustment vouchers without adequately reviewing the vouchers and supporting documentation. About \$44 billion of the \$212.2 billion adjustments weren't supported based on our initial review. However, we were able to reconstruct the audit trail and find support for all but about \$19.1 billion.

Accounts Receivable

We found that inventory management personnel could access and change—without the knowledge or approval of the Defense Accounting Service—the accounts receivable data in the Commodity Command Standard System. The Commodity Command Standard System is the automated system used to account for accounts receivable transactions for the wholesale segment of the Supply Management, Army activity

group. Inventory management personnel need to have access and the ability to change logistical data. However, the ability to directly change accounting information opens the door to data manipulation and unreliable accounting information.

Inventory and Related Property, Net

Inadequate internal controls continue to affect the reliability of amounts reported for the Inventory and Related Property, Net account.

Reconciliations. The Defense Accounting Service didn't reconcile the accounting records with the logistical records to make sure they agreed. Instead it accepted the logistical records as accurate and adjusted the 30 September 2000 accounting records by about \$3.9 billion to make the accounting records agree with the logistical records. Reconciliation is a key internal control to make sure transactions process to both the accounting and the logistical records.

Physical Inventories. Complete physical inventories weren't conducted during FY 00. Inventory values are used in computing the cost of goods sold for the Statement of Net Cost and are also reported on the Balance Sheet. Complete physical inventories are a key internal control to make sure that inventory quantities and values are reliable.

Inventory In-transit

The Army didn't have adequate controls over items in transit. This has been a problem for years. As we reported in prior years, inventory in transit couldn't be verified in previous years due to no audit trail and computed balance issues. Due-in records for shipments from contractors sometimes weren't properly closed out in the Commodity Command Standard System. The primary problem affecting the accuracy of in-transits is that Commodity Command personnel don't research and correct contractor shipment notices when they're rejected by the Commodity Command Standard System. Commodity Command personnel are ultimately forced to resolve uncleared due-in records during the contract closeout process. In some instances, they manually process dummy receipt transactions to correct rejected contractor shipment notices.

Accounts Payable

The Army and the Defense Accounting Service didn't have adequate control over accounts payable. We found that accounts payable transactions that rejected in the Commodity Command Standard System weren't properly researched and corrected. The Army and the Defense Accounting Service didn't reconcile accounts payable balances and they didn't follow procedures to make sure aged accounts payable-public balances were accurate. We also noted that they didn't review and correct invalid materiel receipts that affected the accounts payable amounts reported in the financial statements.

Equity Transactions

There were inadequate controls to make sure equity transactions affecting the Statement of Changes in Net Position were proper. For example, we couldn't find supporting documentation for some transactions that were automatically generated by the Commodity Command Standard System. Also, Army personnel couldn't tell us why the transactions occurred or if they should have occurred. In addition, controls weren't in place to make sure some charges to the fund equity account were proper because we found instances when activities charged depreciation directly against equity, bypassing the cost of operations for the period.

**REPORT ON COMPLIANCE WITH LAWS
AND REGULATIONS**

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REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

The Army and the Defense Finance and Accounting Service (Defense Accounting Service) are responsible for complying with applicable laws and regulations. As part of our efforts to obtain reasonable assurance about whether the Army Working Capital Fund financial statements were free of material misstatement, we performed tests of the Army's and the Defense Accounting Service's compliance with certain provisions of laws and regulations. Noncompliance with these laws and regulations could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in the Office of Management and Budget Bulletin 01-02 (Audit Requirements for Federal Financial Statements), including the requirements referred to in the Federal Financial Management Improvement Act of 1996.

Our objective wasn't to, and we do not, express an opinion on overall compliance with laws and regulations. The results of our tests of compliance with the laws and regulations, exclusive of the Federal Financial Management Improvement Act, disclosed instances of non-compliance that are required to be reported under Government Auditing Standards. However, in our review of compliance with laws and regulations, we found no material instances of unreported legal or regulatory infractions. For those laws and regulations that we didn't test for compliance, nothing came to our attention to indicate any material problems or noncompliance.

We discuss three pertinent laws, the Office of Management and Budget Bulletin 97-01 (Form and Content of Agency Financial Statements), and DOD Financial Management Regulation 7000.14-R in the following paragraphs.

Chief Financial Officers Act

We evaluated the Army's compliance with the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994, and various implementing regulations issued by the Office of Management and Budget and DOD, as they relate to financial statement presentation. The Army and the Defense Accounting Service continued efforts to comply with the act's requirements. However, the Army and the Defense Accounting Service didn't fully comply with the Chief Financial Officers Act. The primary cause is that the management and accounting systems were designed to support reporting requirements

focusing on maintaining accountability for assets and reporting the status of Federal appropriations rather than applying the current emphasis of business-like financial statements.

The Army Working Capital Fund continues to implement process improvements to help it achieve compliance with the Chief Financial Officers Act. The Army and the Defense Accounting Service developed a Chief Financial Officers Act Strategic Plan that outlines actions they must take over the next several years. These actions are to improve and integrate all functional and financial processes and systems that contribute to resolving its management control weaknesses related to complying with the Chief Financial Officers Act.

Until the deficiencies are resolved, the Army and the Defense Accounting Service will be unable to produce statements that conform to prescribed accounting guidance. Nonetheless, we have identified some areas in which the Army and the Defense Accounting Service can achieve financial reporting improvements over the short term. We discuss these areas and the necessary corrective actions in the Report on Internal Controls section in this report. We will also discuss this in separate audit reports that will be issued at a later date.

Federal Managers' Financial Integrity Act

The Federal Managers' Financial Integrity Act of 1982 requires the Army and the Defense Accounting Service to report annually to the Secretary of Defense on whether their management controls comply with the act's requirements. In their respective FY 00 annual assurance statements, the Army and the Defense Finance and Accounting Service-Indianapolis Center for Sustaining Forces (Indianapolis Center) included several weaknesses that affect Army Working Capital Fund operations. We summarize the specific weaknesses most directly related to the fund's financial statements in the following sections.

Army's Annual Assurance Statement

The Army's annual assurance statement for FY 00 included two uncorrected material weaknesses that affect operations. Here's a summary of the weaknesses:

- **Unreliable Financial Reporting of Personal and Real Property.**
The Army doesn't currently meet Federal Accounting Standards for the financial reporting of Real Property and General Equipment. The Statement of Federal Financial Accounting Standard Number

6 (Accounting for Property, Plant and Equipment) identifies four categories of personal and real property and requires that the Army present fairly the cost and related depreciation of these assets in the financial statements. This weakness is scheduled for correction in FY 02.

- **Equipment In-transit Visibility.** Because of automated system problems, the Army doesn't have reliable data on the value of equipment in transit. Therefore, the value of equipment in transit reported in the financial statements may be misstated by a significant but unknown amount. This weakness is scheduled for correction in FY 01.

The second weakness (Equipment In-transit Visibility) was also included as a subset of DOD systemic material weaknesses.

Indianapolis Center's Annual Assurance Statement

In its FY 00 annual assurance statement, the Indianapolis Center reported three internal control weaknesses that affect Army Working Capital Fund operations. Here's a summary of the weaknesses:

- Disbursements that were in transit, unmatched, or applied against specific obligations in excess of the recorded obligation amounts were problems. (Identified during FY 96, target date for completion is FY 03.)
- Suspense account balances require extensive reconciliation to ensure the accounts are properly used, supported by adequate documentation, cleared timely, and in agreement with U.S. Treasury balances. (Identified during FY 97, target date for completion is FY 02.)
- Four weaknesses identified in FY 98 relating to transportation bills and payments, and government bills of lading were consolidated in FY 99 to one weakness. Three weaknesses related to system deficiencies in the Defense Transportation Payment System and the Defense Transportation Payment System-Accounting Module. One weakness identified incomplete preaudits of transportation bills. (Identified in FY 99, target date for completion is FY 02.)

Federal Financial Management Improvement Act

The Federal Financial Management Improvement Act of 1996 requires each Federal agency to implement and maintain financial management systems that comply substantially with:

- Federal financial management systems requirements.
- Statements of Federal Financial Accounting Standards.
- U.S. Standard General Ledger at the transaction level.

We are required to report on whether the agency's financial management systems substantially comply with these requirements. We found that the financial management systems that supported the Army Working Capital Fund weren't in substantial compliance with the requirements of the act. The Defense Accounting Service and the Army are working together to develop and implement a remediation plan to correct system deficiencies. We discuss compliance with the three financial management requirements in the following paragraphs.

Federal Financial Management Systems Requirements

Office of Management and Budget Circular A-127 (Financial Management Systems), 23 July 1993, revised 10 June 1999, requires financial management systems to provide complete, reliable, consistent, timely, and useful information. Agencies are required to:

- Develop and maintain an agency-wide inventory of financial management systems.
- Develop agency-wide systems plans.
- Review financial management systems.
- Develop and maintain agency financial management systems directives.

We found that the financial management systems that supported the Army Working Capital Fund weren't in substantial compliance with the requirements of the act. As discussed in the notes to the financial statements, some systems don't collect and record financial data on the full accrual accounting basis. Reported values and information for major asset and liability categories are derived largely from nonfinancial feeder systems, such as inventory and logistics systems. These systems were designed to support reporting requirements focusing on accountability rather than accrual based accounting. The Defense Accounting Service

is primarily responsible for correcting deficiencies in the accounting systems. The Defense Accounting Service with the help of the Army took steps to comply with the four requirements we discussed previously. However, as discussed in other sections of this report, there were several areas where they didn't fully comply.

Statements of Federal Financial Accounting Standards

Federal agencies reporting under the Government Management Reform Act of 1994 are to follow 18 Statements of Federal Financial Accounting Standards agreed to by the Director of the Office of Management and Budget, the Comptroller General, and the Secretary of the U.S. Treasury. The Army and the Defense Accounting Service recognized that, for FY 00, the financial management systems that support the Army Working Capital Fund didn't substantially comply with Federal Accounting Standards. For example the systems didn't:

- Have documentation supporting the historical cost of Property, Plant and Equipment as required by Statement of Federal Financial Accounting Standard Number 6 (Accounting for Property, Plant and Equipment).
- Recognize accounts payable based on acceptance as required by the Statement of Federal Financial Accounting Standard Number 1 (Accounting for Selected Assets and Liabilities). Instead, the systems recognized payables based on the storage depot reporting the receipts.
- Recognize accounts receivable as required by the Statement of Federal Financial Accounting Standard Number 1. The standard required that a receivable be recognized when the goods or services were provided to the customer. The Army Working Capital Fund recognized the receivable when the message was forwarded to ship the item. The customer didn't receive the item until sometime later.

U.S. Standard General Ledger at the Transaction Level

The Office of Management and Budget requires Federal agencies to implement the U.S. Standard General Ledger in their financial systems. The general ledger must be implemented at the transaction level. Federal agencies are permitted to supplement their application of the general ledger to meet agency-specific information requirements; however, the supplement must maintain consistency.

The Army, the Defense Accounting Service, and, in some cases, other DOD activities are collectively responsible for the financial management systems that support the Army Working Capital Fund. The Army is responsible for the nonfinancial data systems that supply most of the data reported in the financial statements. This data is then fed into the accounting and finance systems that are the responsibility of the Defense Accounting Service. Therefore, the Indianapolis Center used data from the accounting systems and other sources to compile the FY 00 Army Working Capital Fund Financial Statements.

DOD, the Army, and the Defense Accounting Service have acknowledged that their financial management systems have significant procedural and systemic deficiencies. They have included discussions of those deficiencies in previous annual assurance statements and the management representation letter for the FY 00 DOD agency-wide financial statements.

Office of Management and Budget Bulletin 97-01

The Office of Management and Budget Bulletin 97-01 (Form and Content of Agency Financial Statements) provides implementing guidance for preparing the financial statements and incorporates the Statements of Federal Financial Accounting Standards. Our review of the financial statements showed that some lines in the Statement of Financing weren't prepared as required by Office of Management and Budget Bulletin 97-01. Specifically, the Statement of Financing reported a zero balance on line 1.E. Transfers-In (Out). However, line 1.E. should report \$6,725,514. This \$6,725,514 represents the net amount of transfers of assets without reimbursement to the Army Working Capital Fund as reported in the Statement of Changes in Net Position. The Indianapolis Center prepared this line item in accordance with the DOD Financial Management Regulation 7000.14-R, Volume 6B (Form and Content of the DOD Audited Financial Statements). However, the DOD form and content guidance isn't in agreement with:

- **Statement of Federal Financial Accounting Standard Number 7 (Accounting for Revenue and Other Financing Sources).** This statement states that an intragovernmental transfer of cash or another capitalized asset without reimbursement changes the resources available to both the receiving entity and the transferring entity. It states that the receiving entity should recognize a transfer-in as an additional financing source in its results of operations in the Statement of Changes in Net Position. It also discusses the use of information from the Statement of Changes in Net Position to prepare the Statement of Financing.
- **Office of Management and Budget Bulletin 97-01 (Form and Content of Agency Financial Statements).** Bulletin 97-01 provides implementing guidance for preparing the financial statements and incorporates the Statements of Federal Financial Accounting Standards, including the Statement of Federal Financial Accounting Standard Number 7 and also the "Implementation Guide" issued in conjunction with Statement Number 7.

DOD Financial Management Regulation 7000.14-R

The Defense Accounting Service didn't comply with the section of DOD Financial Management Regulation 7000.14-R, Volume 1 (General Financial Management Information Systems and Requirements) concerning adequate documentation to support some adjustments processed by the Indianapolis Center.

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ANNEXES

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AUDIT SCOPE AND METHODOLOGY

Army management, with support from the Defense Finance and Accounting Service, is responsible for:

- Preparing the annual financial statements in conformity with applicable accounting principles.
- Establishing and maintaining internal controls and systems to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act are met.
- Complying with applicable laws and regulations.

We were responsible for reviewing the financial statements and evaluating related internal controls and compliance with laws and regulations. In carrying out these responsibilities, we:

- Obtained an understanding of internal controls related to financial reporting, including safeguarding assets, and compliance with laws and regulations.
- Tested relevant internal controls affecting the:
 - Balance Sheet.
 - Statement of Net Cost
 - Statement of Financing
 - Eliminations and adjustments
 - Financial statement preparation procedures.
- Considered compliance with the process required by the Federal Managers' Financial Integrity Act for evaluating and reporting on internal control and financial management systems.
- Tested compliance with selected provisions of the following laws.
 - Chief Financial Officers Act
 - Federal Managers' Financial Integrity Act.
 - Federal Financial Management Improvement Act.

- Office of Management and Budget Bulletin 97-01.
- DOD Financial Management Regulation, Volume 1 (General Financial Management Information Systems and Requirements).
- Assessed data contained in the Overview section of the Annual Financial Report for consistency with data reported in the financial statements.

The Office of the Inspector General, DOD reviewed some aspects of the compilation and provided us with its results.

We didn't conduct audit work on programs that were classified for national security purposes. We also didn't audit general and application controls in the various automated computer systems.

We didn't evaluate all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to those controls necessary to achieve the objectives outlined in our report on internal controls. Because of inherent limitations in any internal control system, losses, noncompliance, or misstatements may nevertheless occur and not be detected.

We didn't test compliance with all laws and regulations applicable to the Army and the Defense Finance and Accounting Service. We limited our tests of compliance to those laws and regulations discussed previously. We caution that noncompliance other than that discussed in this report may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

To the extent possible, we performed our work in accordance with generally accepted government auditing standards and Office of Management and Budget Bulletin 01-02 (Audit Requirements for Federal Financial Statements). However, as noted in the body of our report, there were limitations to the scope of our work.

OTHERS RECEIVING COPIES OF THIS REPORT

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 Under Secretary of the Army
 Vice Chief of Staff
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 Assistant Secretary of the Army (Civil Works)
 Assistant Secretary of the Army (Financial Management and Comptroller)
 Assistant Secretary of the Army (Installations and Environment)
 Assistant Secretary of the Army (Manpower and Reserve Affairs)
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Audit Team Members

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INTERNET DOCUMENT INFORMATION FORM

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